DOCUMENT RESUME

ED 208 973 PS 012 486

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TITLE Legal Aspects of Child Care as an Employee Benefit. Revised Edition.
INSTITUTION Bay Area Child Care Law Project, San Francisco, Calif.
SPONS AGENCY Bananas, Inc., Oakland, Calif.; Children's Council-Childcare Switchboard of San Francisco, Calif.
PUB DATE Oct 81
NOTE 13p.

EDRS PRICE MF01/PC01 Plus Postage.
DESCRIPTORS Civil Rights Legislation; *Day Care; *Employer Employee Relationship; *Fringe Benefits; *Labor Legislation; *Laws; *Tax Credits
IDENTIFIERS California Fair Employment and Housing Act; *Child Care Legislation; Civil Rights Act 1964 Title VII

ABSTRACT

This document reviews the legal propriety of offering child care to employees and addresses the post-1981 federal income tax consequences of a child care benefit. One issue at hand involves the legal mandate to promote equal opportunity in employment. However, not all employees have the need for child care, and legal questions have been raised regarding whether child care benefits can be offered to a select group of employees. Anti-discrimination laws are analyzed in terms of California state laws, Title VII of the 1964 Civil Rights Act, and two executive orders which prohibit discrimination and require affirmative action. Distinctions in the laws protecting against discrimination are noted, as is the maximum flexibility granted employers in California to provide child care benefits. Various types of benefit programs are considered legal, and selective availability of child care is also permitted under the law. The income tax aspects of child care benefits are reviewed in terms of employer, employee, and provider requirements of Dependent Care Assistance Programs. Key components of the new tax laws include increased expense limits and a sliding credit percentage. The "cafeteria plan," whereby employees may choose appropriate benefits, is also outlined. (Author/DB)

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ED208973

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I. INTRODUCTION

There are many legal issues involved in the establishment of child care as an employee fringe benefit.[1] This article will explore two important issues in this rapidly growing field — the propriety of offering a child care benefit only to employees with children and the present state of the law concerning income tax consequences of the benefit to the employee.

II. CHILD CARE AS A BENEFIT FOR SOME, BUT NOT ALL, EMPLOYEES

By its nature, child care is a benefit of interest to a limited group of employees, i.e., those who are responsible for the care of young children. As a consequence, many questions have arisen concerning the appropriate allocation of the benefit among employees. For example, is it legal to offer child care benefits only to female employees, or to offer the benefit only to employees who are parents of small children and not offer an economically equivalent benefit to other employees? Even more limiting, could an employer legally restrict the benefit to certain groups within the company; for example, employees in a particular department or at a certain salary level?

A. LAWS PROHIBITING EMPLOYMENT DISCRIMINATION

In order to answer these questions, it is necessary to first describe the basic anti-discrimination laws an employer must follow in the treatment of employees. The principles set forth in these laws apply to child care as an employee fringe benefit.

1. Title VII and Executive Orders

On the federal level, the major anti-discrimination law is Title VII of the 1964 Civil Rights Act (Title VII).[2] Federal contractors and sub-contractors are also covered by two Executive Orders which prohibit discrimination and also require affirmative action to ensure equal opportunity.[3]

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[1] The legal issues involved in establishing any employer-supported child care program will vary depending on the type of child care service to be provided. A selected list of relevant publications which treat child care legal issues is given in the Appendix.

[2] 42 U.S.C. Sections 2000e, et seq. For a complete discussion of Title VII and related laws, see Schlei and Grossman, Employment Discrimination Law, Bureau of National Affairs, Washington, D.C., 1976, and Supplement, 1979.

[3] Executive Order No. 11246, 9/24/65, 30 F.R. 12319, as amended by Executive Order No. 11375, 10/13/67, 32 F.R. 14303.

Title VII is enforced by the Equal Employment Opportunity Commission (EEOC)[4] and prohibits employers [5] from discriminating against their employees on the basis of race, color, religion, sex, national origin or reprisal for filing an EEOC complaint.[6] Title VII applies to employers in all states.

2. State Laws

In addition to Title VII, employers must follow the requirements of the pertinent state anti-discrimination laws. In California, the state law is called the California Fair Employment and Housing Act ("California Act")[7] and it is enforced by the California Department of Fair Employment & Housing.[8] California law prohibits discrimination on more bases than does Title VII, i.e., race, religious creed, color, national origin, ancestry, physical handicap, mental condition, marital status, sex, age and pregnancy.[9]

B. ANALYSIS OF ANTI-DISCRIMINATION LAWS

To put these laws in context it is important to note that, in everyday usage, to "discriminate against" someone means to treat that person unfairly in comparison to others. However, as used here, in talking about an unlawful employment practice, discrimination means to treat someone unfavorably in the context of Title VII, the California Act or some other anti-discrimination law. These acts not only have specific bases upon which discrimination is prohibited, but also specific issues upon which it is illegal to discriminate, including hiring, firing, compensation, terms, conditions or privileges of employment and others.[10] Child care assistance or services provided by an employer is a term, condition or privilege of employment similar to a medical plan, a group legal services plan, or an educational assistance program for employees and, as such, is covered by the law.

Thus, in California, with respect to a child care benefit, it is unlawful for an employer to deny the benefit to an employee on the basis of the employee's race, sex, marital status, etc. The employer must make the benefit available to employees without regard to the employee's race, sex, marital status, or other protected bases. In other words, the benefit must be made equally availble to men and women employees, as well as to married, divorced and single employees.

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4 See Equal Employment Opportunity Commission Regulations and Guidelines, 29 C.F.R. Part 1600 et seq.

5 See 42 U.S.C. Sections 2000e for definition of employers and others covered by Title VII; see, also, relevant sections of state fair employment laws.

6 42 U.S.C. Sections 2000e-2.

7 California Government Code Sections 12900 et seq. (Former Labor Code Sections 1410 et seq.).

8 See Fair Employment and Housing Regulations, Title 2, Division 4, California Administrative Code, Sections 7285 et seq. (adopted 1980).

9 California Government Code Section 12940 and Section 12945.

10 42 U.S.C. Sections 2000e-2; California Government Code Section 12940.

As it is clear from the above discussion, the employment discrimination laws do not recognize "non-parenthood" (as opposed to race, sex, etc.,) as a protected basis. Thus, an employer is not required by these anti-discrimination laws to provide child care, or an economically equivalent benefit to the other employees. In fact, for purposes of California law, California Government Code Section 12947, enacted in 1978, specifically authorizes the provision of child care services: [11]

> It shall not be an unlawful practice under this part for an employer or labor organization to provide or make financial provision for child care services of a custodial or other nature for its employees or members who are responsible for minor children.

This section opens the door for California employers to provide child care benefits through the direct operation of a program, financial support, or any other method. There is no limitation in this statute concerning the type of program.[12] In fact, the Legislature went out of its way to provide maximum flexibility on this point by stating that the services may be of any nature.

In an analogous situation, many currently existing benefit plans benefit some employees more than other employees. For example, medical benefits often cover dependents, thereby disproportionately benefiting employees with a large number of children. This practice, too, is explicitly permitted by California law in Government Code Section 12940(a)(3) which states:

> Nothing in this part relating to discrimination on account of marital status shall...prohibit bona fide health plans from providing additional or greater benefits to employees with dependents than to those employees without or with fewer dependents.

Despite the legality of the child care benefits, an employer, as a matter of personnel policy, may wish to equalize employee benefits by offering a menu of benefits through a "cafeteria plan," discussed in Section III, B., below.

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[11] The broadly permissive language of Government Code Section 12947 (see text infra for text of Section 12947) raises the possibility that child care is somehow exempted from the Fair Employment and Housing Act. This interpretation seems so unlikely that the attempt here has been to harmonize Section 12947 with the other provisions of the Act.

[12] But see re: rapid depreciation of child care facilities: Internal Revenue Code Section 188, which requires that the program maintain at least 80% employee children to qualify for Section 188 treatment; and California Revenue and Tax Code Section 17225.5 and Bank and Corporation Tax Law Section 24371.5 which requires programs to meet the requirements of the Child Development Act, Education Code Section 8200 et seq., to qualify for the rapid depreciation of the facility.

From the above it is clear the employer may offer the benefit only to parent employees so long as no inappropriate discrimination is made among those employees.

The question remains whether the child care benefit can be made available to a selected group of employees, e.g., members of a department or employees in a certain salary category. The answer to this question is a qualified "yes." The child care benefits will probably not be unlawful employment discrimination as long as employees to whom the benefit is offered are selected on some rational basis which is not prohibited by the anti-discrimination laws. Thus, it would probably be legal to offer the benefit to only one department or only one salary category. However, to reiterate, once the department or salary category is selected it is unlawful to distinguish among members of that group on a basis prohibited by the anti-discrimination laws. By identifying the department or salary category to receive child care benefits, the employer has, for purposes of this benefit, created a group of "similarly situated" employees and it would be improper to discriminate among them on a prohibited basis. [13]

A potential problem with limiting the child care services to a particular department or salary category is the chance the limitation might result in what is termed "adverse impact" on a group of employees protected by the anti-discrimination laws. For example, if the selected department happened to be 95% female, the male employees might be able to claim that while the selection of that department was ostensibly sex-neutral, in fact, it has had an adverse impact upon men because so few men are in a position to receive the benefit. While California Government Code Section 12947 [14] authorizing child care services offers considerable security against suits brought under the California Act, no equivalent provision exists in Title VII or in most other state laws. Because the law is relatively undeveloped on this point, no clear answers are available. As a consequence, employers would be well advised to consult their labor attorney in advance of implementing a child care program, particularly where the group targeted to receive the benefit is predominately one sex, one race, one ethnic group, etc.

C. CHILD CARE AS PART OF AN AFFIRMATIVE ACTION PROGRAM

An employer may wish to include child care as an enhancement to an affirmative action plan required by government contracts. In addition to the potential positive benefits, such as recruitment and retention of female and minority workers, inclusion of child care in the affirmative action plan may provide a defense to a potential discrimination claim by a non-participating employee.

D. UNION CONSTRAINTS

While beyond the scope of this article, constraints imposed by union contracts should be investigated where appropriate.

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[13] Schlei and Grossman define "similarly situated" as meaning that "the persons who are being compared are so situated that it is reasonable to believe that they would receive the same treatment in the context of a particular employment decision." supra at p.16, n.6, citing EEOC Interpretative Manual Section 132.5 (c).

[14] See n. 11, supra.

III. INCOME TAX ASPECTS OF A CHILD CARE BENEFIT

A. EMPLOYEE BENEFIT PLANS

1. DEPENDENT CARE ASSISTANCE PROGRAMS

A basic rule of tax law is that all items of economic benefit, whether cash or in-kind services, which are received as a result of the employment relationship are to be included in gross income and are subject to tax.[15] In general, exceptions to this rule must be established by statute and many fringe benefits are statutorily excluded from income, including medical and disability benefits, group legal service plans and educational assistance programs for employees.[16] Effective January 1, 1982, child and other dependent care benefits are also excluded from income for federal tax purposes under the new "Dependent Care Assistance Programs" included in the Economic Recovery Tax Act of 1981 (ERTA).[17]

Prior to the passage of ERTA, there was considerable confusion surrounding the federal tax status of a child care benefit paid or made available to an employee by an employer. Many experts believed that, absent a clarifying statute, the value of employer-provided child care services, payments or vouchers would be included in the employee's gross income - and taxed! This problem is solved by the new law - at least for federal tax purposes - for those programs which comply with its terms.

Dependent Care Assistance Programs establish a benefit which is excludable from income for purposes of federal taxes only. The tax treatment for purposes of state and local taxes will vary among states and localities. While some states automatically follow the exclusions established by federal law, many states, including California, have special state rules.

The Internal Revenue Service will be developing regulations which may further define and limit these provisions.

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15 Internal Revenue Code Section 61(a).

16 Medical and disability benefits: Internal Revenue Code Section 105(h); group legal service plans: Internal Revenue Code Section 120; educational assistance programs: Internal Revenue Code Section 127. See Caplin, Mortimer M., "Educational Assistance Programs: A New Fringe Benefit For 1979-1983," Taxes - The Tax Magazine, February, 1979, Vol. 57, No. 2, pp. 75-78. (Commerce Clearing House, Inc., Chicago, Illinois).

17 Internal Revenue Code Section 129.

Pending the development of regulations, the basic requirements for the new Dependent Care Assistance Programs are:

a. EMPLOYER REQUIREMENTS

The employer must prepare a separate written plan of the dependent care assistance program. The program must be for the exclusive benefit of its employees to provide employees with dependent care assistance.

The program must not discriminate in favor of employees who are officers, owners or highly compensated or their dependents. This limitation is further refined to prohibit an employer from spending more than 25% of the amount paid for dependent care assistance on behalf of individuals who hold more than 5% of the stock or capital or profits interest in the employer company.

The employer must notify eligible employees of the availability and terms of the program.

Each year the employer must give the employee a written statement showing the amounts paid or expenses incurred by the employer in providing dependent care assistance to each employee.

The amounts paid under this program are excluded from consideration with respect to social security and F.U.T.A.

b. EMPLOYEE REQUIREMENTS

A single employee may not exclude from income an amount larger than the amount earned during the year. Thus, for example, if a part-time employee earned $4,000 and received a child care benefit of $5,000, the employee would have to pay tax on the $1,000 difference.

In the case of married employees, the excluded income can not exceed the earned income of the lesser earning spouse. This means that an employee with a non-working spouse will have to pay taxes on the total value of a child care benefit.

However, a spouse who is a full-time student for at least 5 months during the year or who is disabled will be assumed to have earned $200 per month if there is one child or $400 per month if there are two or more children. Consequently, a student or disabled spouse may "accrue" up to a maximum of $2,400 or $4,800 worth of excludable income.

c. PROVIDER REQUIREMENTS

The caregiver may be any person except a person for whom the employee or the employee's spouse is permitted to take a personal exemption deduction or a person who is the employee's child age 18 or less. Thus, the caregiver can not be the spouse of the employee or an older sibling of the cared-for child.

Unlike the child care credit, this statute does not require that the child care provided by the employer meet state or local standards.

2. CAFETERIA PLAN

Recently, a significant amount of interest has been focused on the Cafeteria Plan as a mechanism of delivering a variety of benefits to employees and permitting the employees to select the benefits appropriate to them. Few companies have actually implemented such a program, a major exception being the American Can Company in Greenwich, Connecticut where 9,000 salaried employees participate in a cafeteria plan.

The Cafeteria Plan was enacted in 1978 as Internal Revenue Code Section 125. It is a statutory plan under which employees may select from a menu of two or more benefits. The significant feature of the plan is that the benefits offered may include both taxable and non-taxable benefits without converting the non-taxable benefits into taxable benefits. Prior to the enactment of the Cafeteria Plan, if an employee were offered a choice that included both taxable and non-taxable benefits, the mere fact that the choice existed automatically converted the non-taxable benefits into taxable benefits. As a consequence, absent the Cafeteria Plan, the menu option is understandably unattractive to employees.

The current Cafeteria Plan requires, among other things, that the employers prepare a written plan, and prohibits the benefits from being limited to highly compensated employees.

B. EXPANDED CHILD CARE TAX CREDIT

Beginning January 1, 1982, working parents will be able to claim a larger federal child care tax credit as a result of the Economic Recovery Tax Act of 1981 (Internal Revenue Code Section 44A). The new law, which primarily benefits families with adjusted gross income between $10,000 - $20,000, provides an increased credit to all eligible taxpayers. The new provisions do not apply to expenditures for dependent care made during 1981. Many states, including California, provide a dependent care credit for state tax purposes.

The key components of the new federal act are:

- INCREASED EXPENSE LIMITS: The new law provides the maximum expense against which the appropriate percentage credit may be taken will be $2,400 for one child or dependent and $4,800 for two or more. (The current limits are $,200 and $4,000 respectively.)

- SLIDING CREDIT PERCENTAGE: The new law establishes a three-tiered basis for determining the percentage of the child care credit, keyed to the family's adjusted gross income:

  1) Under $10,000: 30%

  2) $10,001 through $28,000: Sliding credit ranging from 29% to 21%, the credit being reduced by 1% for each $2,000 of adjusted gross income, or fraction thereof, over $10,000.

  3) Over $28,000: 20%

The following chart shows the dollar amounts of credits available at different income levels under the new law:

Adjusted Gross Income	Percentage	Maximum Credits: One Child Or Dependent	Maximum Credits: Two or More Children or Dependents
Up to $10,000	30%	$720	$1,440
10,001 - 12,000	29%	696	1,392
12,001 - 14,000	28%	672	1,344
14,001 - 16,000	27%	648	1,296
16,001 - 18,000	26%	624	1,248
18,001 - 20,000	25%	600	1,200
20,001 - 22,000	24%	576	1,152
22,001 - 24,000	23%	552	1,104
24,001 - 26,000	22%	528	1,056
26,001 - 28,000	21%	504	1,008
28,001 and over	20%	480	960

The major requirements of the new law are:

1. PROVIDER REQUIREMENTS: The new law provides that a program serving seven or more persons must comply with state and local laws and regulations in order for the parents' payments to it to be eligible for the child care tax credit.

The caregiver may not be a child of the taxpayer under the age of 18 or a person the taxpayer claims as a dependent.

2. TAXPAYER REQUIREMENTS: Generally speaking, the person claiming the deduction must be employed with income in excess of the expense limits of $2,400 or $4,800, depending on the number of dependents.

The child care costs of married employees are limited to the amount of income earned by the lesser earning spouse. Thus, if a married mother with two children in day care earns less than $4,800 (and her husband earns more), their child care expense will be limited to the amount she earned.

If one spouse is not working, the credit is not allowed unless the non-working spouse is a full-time student for at least 5 months during the year, or is physically or mentally disabled. If the spouse is a student or disabled, the law assumes an earned income for each month of being disabled or in school of $200 for one dependent or $400 for two or more dependents.

3. DEPENDENT ADULTS: In addition to permitting a credit for the costs of care of children, the new law provides that the cost of care of disabled persons over the age of 14 is subject to the credit as long as the dependent spends at least 8 hours of every day in the taxpayer's home. In other words, the credit is available for the costs of out-of-home day care for dependent adults, but not for residential care. The old law limited the adult dependent care credit to expenses for care provided in the taxpayer's home.

Like child care centers, dependent care centers for 7 or more adults must comply with state and local laws and regulations in order for the costs to be subject to the credit.

4. EMPLOYER-PROVIDED BENEFITS EXCLUDED: If an employee receives tax free child care services or subsidy from an employer through a dependent care assistance plan, the credit is not allowed with respect to the value of the benefit received. For example, if an employer pays $1,000 of an employee's total child care costs of $2,400, the employee may take the credit only against the $1,400 paid by the employee.

5. EXTRA INCOME EVERY PAYCHECK: Taxpayers who believe they will qualify for the tax credit may wish to revise their Tax Withholding Form (W-4) to permit them to receive the value of the credit in their regular paychecks rather than waiting to claim the credit at the end of the year on their income tax form. Taxpayers should contact their employer, the IRS information service and/or the person who prepares their tax return to obtain details.

6. NON-REFUNDABLE: The credit is non-refundable, which means that the IRS will not issue a refund to a taxpayer whose child care tax credit exceeds the amount of income tax owed. For example, a taxpayer whose tax liability is $300 and is entitled to a $480 child care tax credit can use the credit to offset the entire $300, thus paying no tax for the year. The taxpayer will not, however, receive a $180 refund for the "unused" portion of the credit.

APPENDIX

Kotin, Crabtree and Aikman, Legal Handbook for Day Care Centers, 6 Faneuil Hall Market place, Third Floor, Boston, MA 02109 (Pre-publication copy available for $20.00 from authors).

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ACKNOWLEDGEMENTS

I would like to thank the following San Francisco attorneys for their kind help in the preparation of this material: John Curran Ladd and Evelyn Lewis of Steinhart, Falconer & Morgenstein; James E. Boddy, Jr., of Morrison & Foerster; James Miller and Dale Brodsky of the California Department of Fair Employment and Housing.